United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

75-7503

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FOR THE SECOND CIRCUIT

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P/S

No. 75-7503

SUSAN TANNENBAUM,

Plaintiff-Appellant,

v.

ROBERT G. ZELLER, et al.,

Defendants-Appellees.

Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

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PRELIMINARY STATEMENT

The Securities and Exchange Commission submits this brief, *amicus curiae*, in response to the invitation of this Court.

At the outset, the Commission believes it is important to note its view that at least some aspects of this action are unique. The plaintiff, a mutual fund shareholder, seeks to hold the investment adviser to that fund liable for complying with and implementing decisions made by the independent directors of the mutual fund with respect to the payment of commissions on the fund's securities transactions. These decisions redounded to the direct benefit of the adviser and, at best, only to the indirect benefit of the fund and its shareholders.

Such conduct might, in the ordinary course, lead ultimately to the conclusion that the adviser and fund directors had breached their obligations under federal law to the fund's shareholders. But here, as we discuss in detail below, the conduct challenged occurred in the context of specific market conditions and practices which are unlikely, if not impossible, to arise again. Moreover, contrary to our general experience in that regard, the fund's independent directors were found, by the lower court, to be truly independent of the defendant investment adviser. And, even though the plaintiff complains of the decisions made by the fund's independent directors, she has pursued her action against the fund's investment adviser (and its principals) for carrying out the decisions of the directors and receiving the benefits flowing from such action.

These factors in particular, but not exclusively, create, in our view, a very narrow factual setting for resolution and, concomitantly, create countervailing equities in favor of the defendants in this case.

QUESTION PRESENTED

The basic question presented by this case, and the issue to which this brief is addressed, is whether fully informed and truly independent directors of a mutual fund are precluded, under the Investment Company Act, from exercising any discretion and good faith business judgment in determining whether to use a portion of the commissions paid by the fund on brokerage transactions to reward broker-dealers which sold fund shares or provided research services instead of recapturing such excess commissions for the fund's direct cash benefit.

The plaintiff claims that, under the Investment Company Act, the defendants -- the fund's investment adviser and persons affiliated with it -- were under an absolute fiduciary duty to use a broker-dealer affiliated with the investment adviser in order to recapture a portion of the fixed minimum commissions applicable to securities transactions on an exchange, and that the determination of the investment company's outside, or independent, directors to follow any different course should not be accorded any legal significance. Defendants argue, and the district court held, that the defendants were subject only to a duty to make full and accurate disclosure to the independent members of the board of directors and that, once the board decided, in a truly independent exercise of reasonable business judgment, not to recapture brokerage commissions, the defendants could not be held liable in damages.

STATUTES INVOLVED

Section 1(b) of the Investment Company Act, 15 U.S.C. 80a-1(b), provides in pertinent part:

> "[I]t is hereby declared that the national public interest and the interest of investors are adversely affected--
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> * * *
>
> "(2) when investment companies are . . . operated [or] managed . . . in the interest of . . . investment advisers . . . or other affiliated persons thereof . . . rather than in the interest of all classes of such companies' security holders;
>
> * * *

"It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

Certain provisions of Section 36 of the Investment Company Act were amended, effective December 14, 1970. Accordingly, for the defendants' conduct prior to that date, the plaintiff is asserting an implied private right of action based on former Section 36, 54 Stat. 841, which provided:

"The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate."

For the defendants' conduct after December 14, 1970, the plaintiff relies on Section 36(a) of the Act, 15 U.S C. 80a-35(a), which provides:

"The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts--

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title."

STATEMENT OF THE CASE

1. The Proceedings Below

Plaintiff, a shareholder of Chemical Fund ("Fund"), brought this derivative action on behalf of the Fund against the Fund's investment adviser, F. Eberstadt and Co., Managers and Distributors, Inc. ("M & D"); M & D's parent company, F. Eberstadt and Co., Inc. ("Eberstadt"), which was a member firm of the New York Stock Exchange and a member of the National Association of Securities Dealers, Inc.; and Robert G. Zeller, vice-chairman of M & D's board of directors and chairman of the board of

Eberstadt (App. A-53).[1/]

Plaintiff alleged that the defendants had caused the Fund to use the excess portion of the brokerage commissions it paid to compensate brokers which performed various sales and research services for the Fund, instead of recapturing such commissions for the Fund's direct benefit.[2/]

This course of action was alleged to have benefited the Fund's adviser. The use of the brokerage commissions to reward brokers which sold fund shares had the effect of stimulating sales, which in turn increased the size of the Fund, and concomitantly, the adviser's management fee which was based upon the fund's size. In addition, the adviser, in its capacity as the Fund's principal underwriter, received a portion of the sales charges paid by new investors. Finally, the research services purchased with the brokerage commissions were allegedly the responsibility of the adviser under its advisory contract with the Fund.

Plaintiff urged that the Fund should have used the excess commissions to reduce its advisory fee by causing these excess commissions to be paid to the adviser's parent, Eberstadt, pursuant to the various arrangements permitted under the rules and practice of stock exchanges. This failure to recapture

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1/ "App. __" refers to pages of the Joint Appendix; "Pl. Br. __" refers to pages of the plaintiff's brief; and "Def. Br. __" refers to pages of the defendants' brief.

2/ For the years 1965 through 1973, the Fund paid approximately $5 million in brokerage commissions on the purchase and sale of the Fund's portfolio securities (App. A-34). From 1965-1970, the Fund, through M & D, allocated approximately $2.4 million of the commissions on portfolio transactions to brokers on the basis of the volume of Fund shares which the brokers sold (App. A-37). During the same period, the Fund, through M & D, allocated approximately $350,000 in commissions on portfolio transactions to brokers which provided research and statistical services (App. A-37). During 1971, 67 percent of portfolio brokerage commissions went to brokers which provided both sales and research services, 20 percent went to brokers which only

(continued)

the excess commissions was alleged to have violated the fiduciary obligation standard of new Section 36(a) of the Investment Company Act, the earlier "gross abuse of trust" standard of former Section 36 of that Act, common law duties of fiduciary obligation, the management and underwriting contract between the Fund and adviser, which allegedly provided that the adviser was to bear the entire cost of research and sales services, and the Fund's charter of incorporation which provided that new shares must be sold for "net asset value." Finally, the complaint alleged a failure to disclose completely and accurately this course of action to the shareholders in violation of the antifraud provisions of the Securities Act of 1933 3/ and the Securities Exchange Act of 1934 4/ and in violation of the proxy solicitation provisions of the Securities Exchange Act 5/ and the Investment Company Act 6/ (App. A-61 - A-62).

2/ (footnote continued)

sold fund shares, and 11 percent went to brokers which provided only research services. The corresponding figures for 1972 were 81 percent for brokers which provided research and sales, 6 percent to those providing only sales, and 13 percent for those brokers which provided only research services (App. A-30 - A-38).

3/ Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a).

4/ Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5.

5/ Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a), and Rule 14a-9 thereunder, 17 CFR 240.14a-9.

6/ Section 20(a) of the Investment Company Act, 15 U.S.C. 80a - 20(a), and Rule 20a-1 thereunder, 17 CFR 270.20a-1.

After a trial on the merits, the district court held that the plaintiff was not entitled to relief. 7/ The court found that the defendants had made full and complete disclosure of all the relevant facts to the independent members of the Fund's board of directors, and that the board had established several committees of noninterested directors which studied the question over a course of several years. As a result of this consideration, the independent directors who were found by the lower court to be truly independent of the adviser had determined not to recapture the excess commissions, but to use them instead to reward those brokers which sold fund shares or which provided research services to the Fund. The court held that the independent directors had exercised a reasonable business judgment in concluding that the use of brokerage commissions to reward brokers was more beneficial to the Fund than recapture would have been. Finally, the court held that the Fund's practices were adequately disclosed in annual reports and prospectuses, and that there was no violation of the management or underwriting contracts because the practices were done with the concurrence of the noninterested directors, who had specifically approved the course of action. Plaintiff appeals from this decision.

* * * * *

In order to understand the issues involved in this case, it is necessary, by way of background, to understand the nature of the mutual fund industry and also the rather complicated mechanisms which evolved in the 1960's for compensating brokerage firms for their services. The following discussion deals with these matters.

7/ The district court's decision is reported at 299 F. Supp. 945.

2. Nature of the Mutual Fund Industry

Much of the difficulty of this case stems from the unusual nature of the mutual fund industry. A mutual fund is, in effect, a pool of liquid assets, belonging, by virtue of their stockholdings in the fund, to many individual investors. This pool of assets is generally controlled almost exclusively by an investment adviser which provides office space, staff, and management services to the fund. The adviser selects the fund's investments and operates or supervises most other aspects of its business. In return for these services, the adviser receives a fee which is almost always a percentage of the fund's net assets,[8/] fluctuating upward or downward as the value of the portfolio changes. The function of selling new fund shares generally is performed by a brokerage operation, denominated the "principal underwriter," which in most cases is either the adviser itself or a close affiliate.

This management structure differs significantly from the structure of industrial corporations. The typical mutual fund is dominated by an external corporate entity -- the adviser. In contrast, in the typical corporation, the controlling management of the corporation is internal --

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8/ The net assets of a fund consist primarily of the value of the portfolio securities held by the fund. This total is adjusted by amounts reflecting the sale of new fund shares or the redemption of old shares, dividends received by the fund because of its securities holdings, interest received on debt obligations held by the fund, and various expenses of operation.

"Net asset value," which is referred to subsequently, represents the net assets divided by the number of shares of the fund outstanding. See generally, Investment Company Act Rule 2a-4, 17 C.F.R. 270.2a-4.

its officers. Leaving aside problems of isolated individual insider transactions, the management of a typical corporation has an incentive to act in the best interests of the corporation because management is paid directly by the corporation and often has a substantial equity investment in the corporation. The individuals comprising an adviser to a mutual fund ordinarily exercise at least as much control over the fund as the internal management of a typical corporation does; yet, the adviser to a mutual fund is comprised of individuals who have their equity investments in a corporation external to the entity they manage and they derive their compensation from that external corporation. Thus, while the management of a typical corporation has the primary goal of maximizing the profit of their own corporation, the adviser to a mutual fund may be motivated primarily by a desire to maximize the profit of the advisory corporation, and this latter profit may, depending on the circumstances, be made at the expense of the mutual fund it manages.

It is not surprising, therefore, that the interests of the adviser and the mutual fund shareholders often conflict. Such a conflict is asserted as the basis of this litigation.

3. The Compensation System in the Brokerage Industry, and the Development of Reciprocal Practices and Recapture Techniques

This litigation arose as a result of certain practices which developed in the 1960's in connection with the fixed commission rate structure imposed by the securities exchanges registered with the Commission. Under that system, a broker which was a member of an exchange was compelled to charge an unvarying minimum commission of

X dollars on a 100 share transaction. If a customer wished to buy or sell 100,000 shares, he paid a commission of 1000X dollars. This system obviously did not reflect economies of scale; it did not cost a broker anywhere near a thousand times as much to execute a 100,000 share order as it cost him to execute a 100 share order. 9/

The problems created by this system did not become apparent until the 1960's, by which time mutual funds and other institutional investors had both grown and become more active in buying and selling large blocks of securities. Although, in the case of mutual funds, the commissions on these transactions were paid by the funds, the frequency of the turnover of the fund's portfolio and the identity of the executing brokers were determined by the advisers. Most advisers used a few lead brokers possessing expertise in executing transactions involving large blocks of securities. Both the advisers and these lead brokers soon recognized that the fixed commissions paid by the mutual funds far exceeded both the actual cost to, and a reasonable profit for the executing brokers. With this realization came the development of numerous devices to recover the excess portions of the fixed commission rate.

The use to which the excess portion of these commissions should be put became the central question. Not suprisingly, advisers found a way to use them to their own best advantage. Most investment companies did not

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9/ Beginning in 1968, the fixed commission-rate system was gradually changed by the introduction, first, of a volume discount, and later, in successive stages, of negotiated rates for transactions exceeding and below certain sizes. Finally, in 1975, the Commission, by adoption of Securities Exchange Act Rule 19b-3, 17 CFR 240.19b-3, abolished fixed commissions entirely.

have their own sales forces to sell fund shares, but instead relied on the salesmen of many brokerage firms to sell shares. These persons were compensated out of the sales load paid by the new investor.[10/] Advisers recognized that, if the excess commissions could be used to increase compensation of these salesmen, they would be inclined to promote the company's shares more vigorously, resulting in an increase in the size of the investment company and, in turn, in the advisory fee, which was based on the amount of the company's assets. In addition, advisers also desired to use the excess commissions to compensate another group of brokerage firms, which possessed no special execution capability but provided sophisticated and thorough research and statistical services.

The solution was to use the so-called "give-up" to compensate both of these groups of brokerage firms.[11/] Advisers would instruct the executing broker to give up a portion of the fixed commission to one or more brokers

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10/ "Sales load" is defined in Section 2(a)(35) of the Investment Company Act, 15 U.S.C 80a-2(a)(35), as "the difference between the price of a security to the public and that portion of the proceeds from its sales which is received and invested or held for investment by the issuer . . . ."

11/ Give-ups had existed long before mutual funds and other institutions began to seek a way to use excess commissions. Basically, the New York Stock Exchange ("NYSE") allowed its members to give up a part of the commissions they earned to another NYSE member on any transaction executed on the floor of the NYSE. This rule was intended to cover the type of situation where, for one reason or another, a member could not service one of its customers and had to have another member do the execution. For example, the customer might have been in a place where his regular broker did not have an office, and so he used another broker who would then rebate part of the commission to the regular broker.

To distinguish this type of give-up from the type employed by the funds, the latter became known as "customer-directed give-ups."

provided research to the fund or sold fund shares. The use of customer-directed give-ups was complicated by the fact that, while most of the fund's brokerage transactions were effected on the New York Stock Exchange ("NYSE"), many of the research and selling brokers were not members of the NYSE at that time, and thus were ineligible, under NYSE rules, to receive give-ups on NYSE transactions. The executing broker, therefore, often effected the brokerage transaction on a regional exchange, 12/ where both it and the research or sales broker were members. The regional exchanges also allowed give-ups, so that a dual member 13/ executing the order on a regional exchange could give up the excess portion of the fixed commission rate to a research or sales broker, which belonged only to the regional exchange.

When customer-directed give-ups were abolished, 14/ it was no longer possible for a fund to use a firm with sophisticated execution capabilities for all of its brokerage orders and have that broker give up the excess portion of the fixed commissions to research and sales brokers. Brokerage

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12/ There are now 12 stock exchanges. Two of these -- the New York and American Stock Exchanges -- are often referred to as the "primary exchanges. Most of the remaining exchanges are referred to as "regional exchanges." See, 2 Securities and Exchange Commission, Report of Special Study of Securities Markets H.R. Doc. No. 95, 88th Cong. 1st Sess., at 911 (1963).

13/ A dual member is a broker-dealer which, in addition to being a member of the NYSE or American Stock Exchange, belongs to at least one of the regional exchanges. Id., at 223.

14/ In its Report to Congress on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d. Sess., 186 (1966) (hereinafter referred to as "Public Policy Report"), the Commission stated that it was giving "notice that it believes that exchange rules must be changed so as to preclude customer-directed give-ups." The NYSE responded to this and other suggestions and prohibited give-ups, effective December 5, 1968.

orders could, of course, be placed directly with these latter brokers, with the understanding that the commissions paid would cover both the normal execution charge and the extra research or sales services. This method did not prove to be practical, however, since many of the research and sales brokers had inadequate execution capability and there were far too many of them to reward in this way. Consequently, other techniques were devised for using commission dollars to reward brokers for sales and research services -- techniques collectively known as reciprocal practices, which did not require any execution capability of a specialized nature.[15/]

Instead of using these give-up and reciprocal devices to reward research or sales brokers, funds could use them to recapture the excess commissions for the funds' direct cash benefit, by arranging for a portion of the commissions to go to a broker affiliated with the adviser.

15/ In "regular-way reciprocity", for example, a mutual fund would approach a broker with execution capability and give it a brokerage order. However, since the executing broker could no longer give up part of the commission to the research or sales broker, the latter had to be compensated in another way. Thus, on a completely different transaction, the executing broker could name the research or sales broker as the "clearing broker," a broker which primarily handles the mechanical details of recording the executed transaction with the exchange, and share some of that commission with the latter because the rules of the exchanges allowed an executing broker to pay a clearing broker a specified amount of the commission.

When the technology of modern communications had developed sufficiently, the mutual funds did not have to rely on these techniques. Instead, they began to negotiate their transactions off the exchange floor. A fund would call a broker and say that it wanted to sell "x" shares of a stock. The broker would find buyers for the stock and tell these buyers to meet on one of the exchanges' floors to consummate the transaction. However, the fund could sometimes negotiate for the finding broker to "step-out" at the last minute and the fund would substitute a research or sales broker to do the actual execution and collect the commission. Although the latter might have no special execution capability, it did not need any since the transaction was already arranged.

The adviser, in turn, was permitted, under the rules of the exchanges, to reduce the amount of its advisory fee by the amount of profits, or a portion of them, derived from the rebates. For example, in the period before give-ups were abolished, the executing broker could be told to give up the excess commission to the affiliate. After give-ups were prohibited, the fund could use the affiliated broker for executing its brokerage transactions, or, if it chose not to, it could use any of the other reciprocal practices which did not require any execution of the fund's transactions by the broker that was to receive a portion of the excessive commissions.

4. The Regulatory Environment.

The Commission's response to this situation involved consideration of many complex factors. In a real sense, the debate, confusion and possibly conflicting views generated by the "recapture problem" were the result of the Commission's dual responsibilities under the Investment Company Act and the Securities Exchange Act.

Under the former, the Commission focused primarily on the effect of the allocation of brokerage commissions on mutual funds, their advisers and their shareholders. At the same time, however, the Commission was more broadly concerned under the Securities Exchange Act with the effect of brokerage allocation on the securities markets. From the latter perspective, the Commission was concerned with such matters as the appropriateness of fixed commission rates, the effect of such commissions on the structure of the securities markets, and the role of the Commission as an economic regulator.

As the Commission's thinking developed on these broader policy issues, and market characteristics continued to change and evolve, the Commission revised its prior positions to accommodate its market concerns. Undoubtedly,

some persons regarded the Commission's later conduct as inconsistent with its prior positions on the narrower issues arising under the Investment Company Act.

This dual approach was apparent from the start of the Commission's statements on the recapture problem. In its Public Policy Report, 16/ the Commission described in detail the mutual fund reciprocal and give-up practices which were used to reward brokers furnishing sales and research services. It then pointed out that some mutual funds had created mechanisms for recapturing excess commissions for the funds' direct cash benefit, and that this course of action probably conferred greater benefits on the funds and their shareholders (Public Policy Report, p. 173). But, when the Commission discussed its legislative proposals for dealing with this problem, it pointed out (id. at 185):

> "Since this report deals largely with mutual funds, it has discussed use of mutual fund brokerage as additional sales compensation primarily in terms of its impact on funds and their shareholders . . . . Apart from the purposes of, and impact on, such investors, the Commission is of the view that certain aspects of these practices, particularly the customer-directed give-up, impair the orderly and proper functioning of the securities markets themselves."

This same duality of approach is reflected throughout the Commission's response to the recapture problem. Thus, the release proposing Securities Exchange Act Rule 10b-10, 17/ a rule which, if adopted, would have required a fund manager to recapture commissions when it had means at its disposal to do so, also discussed a set of proposals submitted by the New York Stock Exchange. These proposals were to introduce a volume discount in brokerage commissions and to make several changes in NYSE rules to eliminate give-ups and other reciprocal practices because they created

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16/ See n. 14, supra.

17/ Securities Exchange Act Release No. 8239 (Jan. 26, 1968).

undesirable distortions in the market. [18/] As the Commission explained, Rule 10b-10 was intended to address this problem in a different way by removing the economic benefits derived by investment advisers from these practices. The Commission stated:

> "Proposed Rule 10b-10 represents an approach to the give-up problem which would not require significant change in the existing commission rate structure of exchanges nor require all exchanges to adopt a uniform approach to the question of give-ups and reciprocal business.
>
> "While the New York Stock Exchange proposal and proposed Rule 10b-10 are not mutually exclusive on all points, the New York Stock Exchange proposal is, to a significant extent, an alternative approach."

Proposed Rule 10b-10 was later withdrawn; the Commission ultimately determined to adopt an alternate approach approximating that suggested by the Exchange.

Similarly, while the Commission did suggest, in the context of the settlement of specific lawsuits under the Investment Company Act, that it would be appropriate for mutual funds to form brokerage affiliates for the purpose of recapturing brokerage commissions, [19/] it eventually concluded that such affiliations were not in the best interests of the securities markets. Thus, it promulgated Rule 19b-2 under the Securities Exchange Act to prohibit membership on exchanges by certain brokers affiliated with institutional investors. In its release announcing the effectiveness of this rule, [20/] the Commission again made clear the differing focus of

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18/ During the period commencing in 1968, when the Commission undertook a massive review of exchange practices, and particularly commission rates, the Commission directed much of its comments and proposed reforms to the NYSE. But its proposals were intended to, and in fact did, apply to the other exchanges as well. See, e.g., Securities Exchange Act Release No. 9950 (Jan. 16, 1973).

19/ See the *amicus curiae* memoranda filed by the Securities and Exchange Commission in *Kurach* v. *Schlusselberg*, 67 Civ. 93 (S.D. N.Y. 1969) and *Gross* v. *Moses*, 67 Civ. 4186 (S.D. N.Y. 1971).

20/ Securities Exchange Act Release No. 9950 (Jan. 16, 1973).

its comments on recapture. After reviewing some of its prior statements on the desirability of using brokerage affiliates to recapture commissions, the Commission stated that it was "difficult to see any inconsistency between the above position and Rule 19b-2, particularly when it is noted that the above position dealt with the conduct of fiduciaries in a given set of circumstances . . . whereas Rule 19b-2 deals with the proper membership structure of a central market system." 21/ It is possible, however, to read certain Commission statements intended to deal primarily with the Commission's approach to restructuring the securities markets as being intended to deal with the narrower problems of investment companies and their shareholders.

In summary, during this period of rapid changes in the securities markets, the Commission sometimes viewed the problems created by the customer-director give-up as a "mutual fund" problem, but, more frequently, and finally, it determined to deal with this practice as a problem of commission rates and market structure. Because of this dual nature of the Commission approach, it is difficult to find guidance -- in the context of this lawsuit, involving a specific fact situation raising questions of the fiduciary obligation of investment advisers -- in many of the Commission's general statements on the recapture problem. That does not mean that the history of the Commission's response to the recapture problem is unimportant; on the contrary, it illustrates the dynamic and constantly changing background in which the defendants' actions in this case must be judged.

21/ Id. at 95. Reflecting further consideration of these market structure issues, the Commission has since rescinded Rule 19b-2 in response to Congressional reports accompanying the recent amendments to the Securities Exchange Act. See, e.g., S. Rep. No. 94-75, 94th Cong., 1st Sess., at 67 (1975).

INTEREST AND SUMMARY OF POSITION OF THE SECURITIES AND EXCHANGE COMMISSION

Pursuant to the Commission's responsibility to administer the federal securities laws, this agency is interested in assisting judicial interpretation of these laws "to make effective the congressional purpose"[22/] and, in particular, to suggest approaches and interpretations of those laws which will enhance the protections available to public investors while at the same time maintaining the degree of discretion necessary for the successful business operation of those members of the industry subject to the Commission's regulation.

This is a particularly difficult task in cases arising under the Investment Company Act. As a result of the peculiar structure of the investment company industry discussed above, the problem of conflicts between the interests of the public investors and the adviser is not merely acute, but is, "so far as management is concerned, the order of the day."[23/] The Congress has chosen a multi-faceted approach to this problem that necessarily compels different approaches by the courts depending on the fact situation involved. These approaches differ, essentially, in the degree of discretion that is to be accorded the investment company's board of directors in making a particular determination.

22/ J. I. Case Co. v. Borak, 377 U.S. 426, 433 (1964).

23/ Moses v. Burgin, 445 F.2d 369, 376 (C.A. 1), certiorari denied, 404 U.S. 994 (1971).

In this case, the Fund's noninterested directors, who were found by the district court to be truly independent of the Fund's adviser, made a decision on a matter involving policy considerations affecting general practices in the investment company industry and the overall structure of the securities markets. The changing market conditions and evolving regulatory precepts during the period involved in this case argues for a judicial approach permitting some exercise of discretion by the board of directors whether to recapture excess brokerage commissions for the fund, or whether to use them to reward brokers for sales of fund shares and research. Specifically, the decision of the board of directors of this investment company -- to forego recapture of excess brokerage commissions -- should be dispositive <u>if</u> this Court satisfies itself that --

(1) in so deciding, the independent directors were truly independent of domination by or undue influence of the adviser;

(2) the independent directors were completely informed, and fully aware, of the available alternatives; and

(3) the decision reached was a reasonable business judgment made after a thorough review of all relevant factors by the independent members of the board. 24/

24/ This brief is addressed only to an interpretation of the fiduciary obligations imposed on advisers of mutual funds by the Investment Company Act. Therefore, we take no position on the extent of the fiduciary obligations which may be imposed under the common law.

Similarly, we take no position on the remaining issues not arising under the federal securities laws -- the plaintiff's arguments based on the advisory and underwriting contracts and on the charter of incorporation.

We likewise take no position with regard to the claims arising under the securities laws and based upon the lack of adequate disclosure of the Fund's brokerage practices to the shareholders. This issue

(continued)

ARGUMENT

IN VIEW OF THE NATURE OF THE QUESTION WHETHER TO RECAPTURE EXCESS BROKERAGE COMMISSIONS, COUPLED WITH THE CHANGING MARKET STRUCTURE AND REGULATORY APPROACHES DURING THE PERIOD INVOLVED, THE DISTRICT COURT PROPERLY CONCLUDED THAT THE FUND'S INVESTMENT ADVISER SHOULD NOT BE HELD LIABLE FOR IMPLEMENTING A REASONABLE BUSINESS JUDGMENT WHICH WAS FOUND BY THE COURT TO HAVE BEEN MADE BY FULLY INFORMED MEMBERS OF THE FUND'S BOARD OF DIRECTORS, ACTING INDEPENDENTLY OF THE FUND'S INVESTMENT ADVISER.

A. The Scope of Discretion Given to the Board of Directors of a Mutual Fund

1. The Structure of the Investment Company Act

During the period from 1938 to 1940, the Commission, pursuant to a direction of the Congress, 25/ conducted a study of the investment company industry and found that, to an alarming extent, investment companies had been operated in the interests of their managers and to the detriment of their shareholders. 26/ Insiders often viewed investment companies as sources of capital for ventures of their own, and as captive markets for unsaleable securities that they, as insiders, wished to convert into cash. Controlling persons frequently took advantage of the companies in

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24/ (footnote continued)

is primarily an evidentiary question as to the correctness of the district court's finding that that disclosure was adequate.

In line with the Commission's general policy when it appears amicus curiae, we have not made an independent review of the record so as to form conclusions on the factual issues involved in the case. Rather, this brief expresses only the Commission's views as to the appropriate legal standards applicable under the federal securities laws.

25/ See, Section 30 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-4

26/ Securities and Exchange Commission, Report on Investment Trusts and Investment Companies, House Doc. No. 136, 77th Cong., pt. 3, pp. 2640-2720 (1938-1940).

other ways, often using broad exculpatory clauses to insulate them from liability. Outright larceny and embezzlement were not uncommon. 27/

This situation led Congress in 1940 to consider various legislative solutions. As originally introduced, the bill which was later to become the Investment Company Act dealt with conflicts of interest by requiring a complete divorce of the sales, management and investment functions within investment companies and by providing for separate and unrelated personnel to handle each. 28/ These provisions were strenuously opposed by the industry and just as strenuously urged by the Commission. 29/

The Act, as finally enacted, provided specific controls to eliminate or mitigate the abuses resulting from dishonesty of, loans to, and unfair property and securities transactions with, insiders. For example, Section 17 of the Act, 15 U.S.C. 80a-17, prohibits transactions between certain affiliated persons and their investment companies in the absence of a prior determination by the Commission that the terms of a proposed transition are reasonable and fair. The Act did not impose

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28/ See, Hearings before a Subcommittee of the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. 37 (1940).

29/ S. 3580, Section 10. See, Senate Hearings, supra n. 27. at 206-223.

30/ Id. at 409-18, 419-20, 509-14, 557-60, 621-23, 642-49, 651-63, 877-92, 893-906.

analogous controls on compensation for services -- sales loads, managerial compensation, and brokerage commissions. In this area, fund managers retained a measure of discretion. Their discretion was subject to control, however, primarily through the provision of specific requirements with respect to the composition of the boards of directors of investment companies. Section 10 of the Act, 15 U.S.C. 80a-10, required each registered investment company to have a board of directors, at least 40 percent of which had to consist of persons who were neither officers nor employees of the investment company and who were unaffiliated with its investment adviser. In the statutory sense, however, unaffiliated did not mean completely unrelated. Section 2(a)(3) of the Act, 15 U.S.C. 80a-2(a)(3), defined affiliation in terms of an ownership or employment relationship, and, therefore, directors unaffiliated with the investment adviser could be -- and sometimes were -- relatives or close friends of their affiliated colleagues. 30/

In reality, the control which Congress intended the unaffiliated directors to exercise did not effectively materialize. This was particularly true in those areas where the conflict of interest was most

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30/ *Public Policy Report*, *supra*, n. 14, at 67-68.

acute, such as the level of the adviser's compensation.[31] By 1962, it could be suggested in the Wharton Study of Mutual Funds, a detailed examination of the investment company industry, that unaffiliated directors "may be of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser."[32] As elaborated by the Commission four years later in its Public Policy Report:

31/ See, *e.g.*, *Lutz* v. *Boas*, 39 Del. Ch. 585, 171 A. 2d 381 (1961), where the court held an investment adviser liable for excessive management fees. The court also held the non-affiliated directors liable, stating (171 A. 2d at 395-396):

> "These men are prime examples of what can happen when a man undertakes a substantial responsibility with public overtones without any appreciation of his obligation thereunder. Based upon my view of the evidence I make certain findings of fact: these non-affiliated directors gave almost automatic approval to the management Agreement; they did not examine the registration statements carefully; they did not discuss securities at their meetings or discuss any of the other facts which would have been pertinent to a reasonable discharge of their duties; most of the time at the directors' meeting was spent in determining dividends on the basis of work sheets provided by the [adviser]; the directors did not know who selected securities for purchase or sale; they did not inform themselves about the rate of turnover and how the brokerage business was being distributed."

32/ A Study of Mutual Funds, submitted to Congress by the Securities and Exchange Commission, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 34 (1962).

(footnote continued)

"The unaffiliated directors usually have other occupations and necessarily cannot devote unlimited time to their directorial duties -- duties for which they, like other corporate directors who are not part of full-time management, seldom receive more than minimal compensation. They also have no staff of officers and employees who work for and are compensated by the fund. In most cases, even the fund's counsel is the adviser's as well. Hence, the unaffiliated directors necessarily obtain most of their information about fund operations from persons who also owe allegiance to, and obtain the preponderance of their compensation from, the adviser - underwriters who cannot be expected to look at such matters as advisory fees in a disinterested way." 33/

Congress in 1970 reconsidered the problem of the controlling influence exerted by the investment adviser, and arrived at a solution which encompassed the existing mechanisms, but also provided for new and more stringent safeguards for public investors in investment companies. In reaffirming its desire to require independent directors

"to supply an independent check on management and to provide a means for the representation of shareholder interest in investment company affairs," 34/

32/ (footnote continued)

The Wharton Study also found that no control over the management was exercised by shareholders because of their large numbers, their small holdings, and the fact that it is easier to redeem mutual fund shares and place investments elsewhere than it is to force a change in management policies. Id. at 64.

33/ Public Policy Report, supra, n. 14, at 131.

34/ H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970).

Congress took several steps beyond its original formulations.

In order to provide greater protection than had been accorded by the use of the term "affiliated," Congress added Section 2(a)(19) to the Act, defining the term "interested person" to include persons who have close family or substantial financial or professional relationships with investment companies, their investment advisers, principal underwriters, officers and employees. This new concept was substituted for "affiliated" in the requirements of Section 10 relating to the board of directors, so that the board would henceforth have to be composed of at least 40 percent "non-interested" persons.

Congress also amended Section 15 of the Act, 15 U.S.C. 80a-15, which governed ratification of advisory and underwriting contracts by the board of directors. Although the board of directors retained its responsibility for the contracts, Congress made several changes "intended to assure informed voting on matters which require action by the board of directors of registered investment companies". 35/ These amendments require personal attendance at meetings where votes are taken, and also explicitly require investment advisers to furnish to the directors all of the information reasonably necessary to evaluate the management contract. Finally, the amendments specifically confirm the duty of the directors to evaluate such information in accordance with the best interests of the fund and its shareholders.

35/ Id. at 76.

At the same time that Congress strengthened the control exercised by noninterested directors, it substantially enlarged the judicial remedies available to investors and the Commission if the noninterested directors should fail in their statutory responsibilities.

Prior to the 1970 amendments, Section 36 of the Investment Company Act had authorized Commission injunctive actions, and, by implication, private damage action by investors, 36/ against fiduciaries only for a "gross abuse of trust." The 1970 amendments modified the language of Section 36 to authorize, in what became Section 36(a), actions for a "breach of fiduciary duty involving personal misconduct." Congress also added a subsection (b) to Section 36, which provides for a private right of action for unreasonable compensation paid by an investment company to its investment adviser. 37/ This subsection further states

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36/ See Fogel v. Chestnutt, [Current Binder] CCH Fed. Sec. L. Rep. ¶95,393 (C.A. 2, 1975); Moses v. Burgin, supra; Tanzer v. Huffines, 314 F. Supp. 189, 245, (S.D.N.Y.), affirmed, 295 F.2d 415 (C.A. 2, 1961); Brown v. Bullock, 194 F. Supp. 207 (S.D.N.Y.), affirmed, 294 F.2d 415 (C.A. 2, 1961).

37/ Defendants argue in their brief that this Court should not imply a private right of action under Section 36(a), but cite only one district court decision, Monheit v. Carter, 376 F. Supp. 334 (S.D. N.Y., 1974), in supprt of that proposition.

There is no merit to the argument that Congress, whose primary purpose in amending Section 36 was to enlarge the remedies available to private plaintiffs, at the same time intended to take away one of the rights already implied under former Section 36. Indeed, to dispel any doubts, the reports of both houses of Congress on the 1970 amendments state that

> "the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)."

S. Rep. No. 91-184, 91st Cong., 1st Sess. 16 (1969); H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 38 (1970).

that approval of the compensation by the board of directors is not conclusive, but "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 38/ The Senate Report which accompanied an earlier draft of the amendments to Section 36, containing language quite similar to that eventually adopted by Congress, stated:

> "These provisions stress the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors in managing and controlling the everyday affairs of the corporation. This section is designed, however, to strengthen the ability of the unaffiliated directors to deal with management compensation, which raises serious conflict-of-interest problems, and to provide a method through which the Federal courts can effectively enforce the statutory provision that management compensation be reasonable. The section is in no way intended to shift the responsibility for managing a corporate enterprise from the directors of a corporation to the judiciary." 39/

Thus, the approach chosen by Congress in 1970 was that of increased control by independent members of the board of directors exercising their business discretion in the best interests of the fund shareholders, combined with external checks on that discretion by federal courts at the behest of the Commission or private plaintiffs.

38/ An earlier draft of the bill which eventually became the 1970 amendments excluded from the provisions of Section 36(b) all contracts approved by the unaffiliated directors. This draft was opposed by the Commission on the ground that the directors, in fact, exercised little control over the adviser's compensation. See H.R. Rep. No. 91-1382, *supra*, n. 37, at 86-87.

39/ S. Rep. No. 91-184, *supra*, n. 37, at 7.

In certain situations, such as looting or waste of corporate assets, limitations on the exercise of discretion by the board of directors would exist in any event by reason of common-law fiduciary principles applicable to ordinary corporations as well as investment companies. However, in some situations where the boards of directors of ordinary corporations would typically be allowed some discretion, the Investment Company Act, in recognition of the unusual structure of the industry, provides that the board will have no discretion. One such situation, transactions between the adviser and the investment company, has already been noted (see p. 22 , _supra_). While the common law of fiduciary obligations, in some jurisdictions at least, would allow a disinterested majority of the board of directors of a corporation to ratify a transaction between a director and the corporation,[40] Section 17 of the Investment Company Act provides that the affiliated person must come to the Commission and obtain prior approval of the transaction.

That is not to say that, where potential conflicts of interest are involved, the Investment Company Act contemplates no role for the discretion of the board of directors. Even with respect to the advisory contract, as to which, as earlier noted (p. 27, supra), Section 36(b) imposes certain judicial controls, the Act specifically contemplates a role for the directors in approving the contract,[41] as it also does in the

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40/ Ballantine, _Corporations_ §67 (1946 ed.); Cary, _Cases and Materials on Corporations_, p. 552 (4th ed. 1969.)

41/ See Section 15(c), 15 U.S.C. 80a-15(c).

selection of an accountant.[42]

Plaintiff argues that the recapture decision which was made by the Fund's board of directors in the present case was not a matter as to which the directors could properly exercise discretion; rather, plaintiff contends there was an absolute fiduciary duty to recapture the excess brokerage commissions for the Fund's direct cash benefit. Defendants, on the other hand, urge that recapture was a matter for the exercise of informed discretion by the directors. The resolution of this issue necessitates an analysis of two appellate decisions which bear upon the issue.

2. The Moses v. Burgin and Fogel v. Chestnutt Opinions

Moses v. Burgin, 445 F. 2d 369 (C.A. 1, 1971), was an action brought against a mutual fund, its investment adviser, its underwriter, and several directors of the mutual fund, based on an alleged breach of fiduciary duty arising out of the defendants' failure to recapture brokerage commissions. The district court held for the defendants, but the court of appeals reversed and remanded for a determination of the proper damages. While the Moses opinion does have relevance to this case, we believe that the reasoning of the court of appeals has been misinterpreted by plaintiff.

Plaintiff argues (Pl. Br. 9-10) that the court of appeals

42/ See Section 32(a)(1), 15 U.S.C. 80a-31(a)(1).

See also, Conviser v. Simpson, 122 F. Supp. 205 (D. Md., 1954), where the court held that it was not an abuse of discretion for the board of directors of an investment company to decide that the company should retain realized capital gains instead of distributing them to the shareholders.

in Moses expressly overruled the contention of the defendants in that case that the failure to recapture could be immunized under a business judgment rule. She cites a portion of the Moses opinion where the court discussed the defendants' contention that, "if recapture was in fact practical, the directors still had a right to choose between recapture of give-ups for Fund's direct benefit, and awarding them to brokers for the Fund's indirect benefit" (445 F.2d at 374). She then states that the First Circuit's response was "clear and direct" when it said:

> "We hold, however, that if recovery was freely available to Fund, the directors had no such choice."

Id. Thus, plaintiff concludes, the Moses decision held that the defendants were under a legal duty to recapture the excess commissions.

It is important to consider, however, what the court of appeals perceived as the source of that legal duty to recapture. In the paragraph immediately following the statements quoted by plaintiff, the court of appeals explained its holding in the following manner (445 F.2d at 374):

> "We cannot, therefore, consider absolving the defendants, if we find that they have violated any duty owed the Fund, by finding that directing give-ups to brokers benefitted Fund by stimulating sales of its shares. Such application violated its charter if it would have been practicable to obtain the give-ups for direct benefit of its treasury . . . .
>
> This is not, of course, to say that the [district] court was not justified in finding that it was beneficial to existing shareholders to promote sales of Fund's shares, as well as being beneficial to [the adviser] and to [the underwriter]. It is merely that, by the terms of the charter, Fund cannot use free money, or credit, to pay brokers for sales" (emphasis added).

Therefore, while this portion of the Moses opinion may be relevant to plaintiff's claim that the failure to recapture in the present case violated the Fund's charter of incorporation, an issue on which we take no position, it is not relevant to the question of the adviser's fiduciary obligation under Section 36.

The reasoning of the Moses opinion that is relevant to the latter issue supports an approach quite different from the one advocated by plaintiff. The court of appeals began its discussion of the fiduciary obligations of the adviser by stating (445 F.2d at 376):

> "Management defendants admit that they gained from the give-up practice, while asserting that Fund also benefited from the resulting growth. To the extent that they, or the court in finding for them without finding full disclosure, implied that their self interest could not influence the decisions to be made on behalf of the fund, Congress had an answer. It responded to this problem by enacting a mandatory provision for unaffiliated, that is, independent, watch dog directors."

After holding that the Congressional provision for unaffiliated directors implied that the directors be kept fully informed by the adviser, the court of appeals discussed the defendants' claim that recapture was not mandated because its effect on fund operations was uncertain, responding (445 F.2d at 383):

> "But in any event, it was the directors of the Fund, not management, who were the ones to make the decision. That they need not have decided to experiment is irrelevant. The court's ruling does not excuse management from its failure to disclose and so permit the unaffiliated directors to decide.

The conclusion in the Moses opinion that the adviser was under a fiduciary duty to disclose information to the unaffiliated directors so that they could exercise their discretion in the recapture area

was recently approved by this Court in Fogel v. Chestnutt, [Current Binder] CCH Fed. Sec. L. Rep. ¶95,393 (Dec. 30, 1975). The plaintiff in Fogel alleged that the investment adviser of a mutual fund had failed to disclose to the non-interested directors of the fund the possibility of recapturing brokerage commissions. The district court had held for the defendants, primarily on the ground that, on the facts of that particular case, recapture was not, in fact, possible.

Judge Friendly, writing for this Court in reversing the lower court, began his opinion by quoting from the holding in Moses that an investment adviser is

> "'under a duty of full disclosure of information to . . . unaffiliated directors in every area where there [is] even a possible conflict of interest between their interests and the interest of the fund.' Moses v. Burgin, supra, 445 F.2d at 376."

After a review of the evidence in the record in Fogel on the question of adequate disclosure, Judge Friendly concluded that the defendants had violated their fiduciary duty to the fund by not apprising the directors of all the relevant facts.[43/] He then stated (id. at p. 98,996):

43/ The plaintiff in Fogel also made an argument, similar to the one made by the plaintiff in Moses and by plaintiff in this case, based upon the fund's charter provision on "net asset value." The intent of such a provision is to assure that a mutual fund charges full value for its shares. If one share represents 1/1000 of the fund, the price must be 1/1000 of the net value of the funds assets. Plaintiff's argument in the present case is based on the reasoning that, when the Fund compensates salesmen, through the use of reciprocal brokerage practices, over and above the percentage of the sales load paid by the purchaser of the shares, the Fund does not receive full net asset value, but rather actually receives only the net asset value minus the money it paid to the salesman through the reciprocals.

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"Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' S. Rep. No. 91-184, 91st Cong. 2d Sess. at 4927 (1970). The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.

If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort at recapture, we would have a different case. But when there has been inadequate communication to the independent directors, it is no defense to the Adviser and those exercising control over it that a decision not to recapture, taken after proper communication, would have been a 'reasonable business judgment'" (footnotes omitted). 44/

43/ (f[illegible]note continued)

Although we take no position on this issue involving the interpretation of a charter provision, we note that in Fogel this Court stated, with respect to that issue (id. at 98,992):

> "Although the argument is not without force, we think it presses too far. The term "net asset value" is one of art in the mutual fund industry and is elaborately defined in the certificate of incorporation. The objective of the charter provision was to prevent dilution of per share net asset value by the issuance of new shares at a discount; defendants' failure to recapture part of the commissions on portfolio transactions does not result in such dilution."

44/ See also, Schlusselberg v. Colonial Management Associates, Inc., 389 F. Supp. 732 (D. Mass. 1974), where the court, in approving a settlement of a lawsuit based on a failure to recapture excess brokerage commissions, concluded that the change from an independent broker-dealer for execution of the fund's brokerage transactions to an affiliated broker-dealer should be a "discretionary decision for directors."

3 The Applicable Scope of Discretion in the Present Case

Neither the Moses opinion nor the Fogel opinion reached the issue presented in this case: whether -- in a situation where the independent directors are found to be truly independent of the adviser and fully informed of all relevant facts -- the decision to recapture brokerage commissions is a matter within the discretion of the board of directors. However, it is logical to assume from the holdings of those cases -- holdings that liability should be imposed on the advisers for failure to make adequate disclosure to the independent directors -- that the required disclosure was for the purpose of allowing the directors to make a decision and thus exercise at least some measure of discretion on recapture.

That the question of recapture is a matter as to which the board may exercise discretion is also supported by the structure and legislative history of the Investment Company Act. There is no specific provision in the Act, such as Section 17 relating to self-dealing transactions, that would explicitly remove the decision on recapture from the discretion of the board of directors. While this factor is not dispositive, it does indicate that Congress did not believe that the potential for abuse in this type of decision was sufficient to warrant statutory removal of the matter from the board of directors' discretion.

Absent a specific controlling statutory provision, it is necessary to look to the general fiduciary obligation provisions of the Act. Prior to the 1970 amendments, Section 36 spoke of a "gross abuse of trust." In 1970, Congress strengthened this language to prohibit a "breach of fiduciary duty," but only a breach involving "personal misconduct." The House Report on the amendments states that the purpose of the phrase "personal misconduct" was to make clear that the section was "intended to deal only with such violations committed by individuals," and that it was

not intended "to provide a basis for the Commission to undertake a general revision of the practices or structures of the investment company industry." 45/ We believe that the language of both former Section 36 and Section 36(a) indicates that Congress did not intend to displace the discretion of the board of directors in decisions involving general policy questions relating to the overall structure of the industry. As noted previously, the decision on allocation of brokerage commissions was inextricably related to the general structure and practices of both the investment company industry and the securities markets. And, as we have shown, the structure and practices were by no means static. On the contrary, decisions had to be made in a constantly changing environment.

Thus, we believe that former Section 36 of the Investment Company Act and present Section 36(a) do not remove the type of recapture determination involved in this case from the discretion of the independent members of the board of directors. 46/ This conclusion assumes, however,

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45/ H.R. Rep. No. 91-1382, supra, at 37. The original bills in the 90th Congress leading to the 1970 amendments had simply authorized actions based upon "breach of fiduciary duty." The qualifying phrase "involving personal misconduct" was introduced in response to industry concerns that that original provision would give the Commission and the courts undue authority to require significant changes in the structure and methods of doing business in the mutual fund industry. Implicit in this was a desire to leave to the board of directors more discretion to determine whether such changes should or should not be made. See, Hearings before the Senate Committee on Banking & Currency, 91st Cong., 1st Sess. 19 (1969).

46/ We wish to stress that the mere fact that there is uncertainty in a particular area does not necessarily mean that liability can be avoided on the basis of an exercise of discretion by the board of directors. Fiduciary obligations still exist. Even in the area of recapture, certain matters are not within the board's discretion. For example, if the directors in this case, instead of deciding to use the excess brokerage commissions to pay for sales and research services, had directed the excess to be paid to the adviser's broker affiliate, there would have been no discretion to permit the adviser to retain the benefits. Fiduciary principles would have required that the excess commissions be returned to the Fund. See, Matter of Provident Management Corp., [1970-71 Transfer Binder] ¶ 77,937 (1970); Matter of Arthur Lipper Corp., Securities Exchange Act Rel. No. 11773 (Oct. 24, 1975), appeal pending, C.A. 2, No. 76-4067.

assumes, however, that the predicate for the Congressional intention to allow the board of directors to function where there is a conflict of interest -- that the board will not be dominated by the adviser but rather will act in the best interests of the fund shareholders -- has been satisfied. Our experience is that rarely are the independent directors truly independent of domination by the adviser. We cannot say, however, that there can never be a case where the independent directors act truly apart from domination by the adviser. In this case, the district court found that the directors were independent of the adviser, and, should this Court determine after a review of the record that that finding was correct, we believe that the matter of recapture was properly within the area of the board's discretion, 47/ absent a formal exercise by the Commission of its broad rulemaking authority under either (or both) the Securities Exchange Act and the Investment Company Act.

While we thus do not believe that Section 36 should be construed to remove the recapture decision from the discretion of the board of directors, it does impose restraints on the exercise of that discretion. The fiduciary obligations of Section 36 impose a duty on the adviser to make effective disclosure to the independent directors and to show that those directors fully appraised all the relevant facts and reached a reasonable business judgment. The remainder of this brief will discuss the criteria we believe should be used in determining whether the defendants in this case fulfilled these conditions.

47/ Our experience with respect to the question of actual independence of directors leads us to suggest that the burden of demonstrating independence of action be a heavy and convincing one on the defendant.

B. The Requirement of Full Disclosure to the Independent Directors

Both the Moses and Fogel opinions dealt primarily with the first prerequisite to an informed decision by the independent directors -- full disclosure of all relevant facts by the adviser. Thus, in Moses the court stated (445 F.2d at 377):

> "Except where it may be fairly assumed that every unaffiliated director will have such knowledge, effective communication is called for. And, in testing that assumption, it must be borne in mind that they are not full time employees of the fund and it may be -- as with Fund's unaffiliated directors -- that neither their activities nor their experience are primarily connected with the special and often technical problems of fund operation. If management does not keep these directors informed they will not be in a position to exercise the independent judgment that Congress clearly intended."

Judge Friendly quoted this language from Moses in the Fogel opinion, where this Court rested its holding on the fact that the disclosures made to the directors did "not add up to the effective communication of a problem to the independent directors mandated by Moses."48/

48/ See also, the Commission's opinion in Imperial Financial Services, Inc. CCH Fed. Sec. L. Rep. ¶ 77,287, at p. 82,464 (1965), where the Commission stated:

> "The significance of the requirement of unaffiliated directors to provide a responsible and objective observation and consideration of the activities of a fund's managers is seriously lessened if such directors do not play an active role in management or if they are uninformed in important matters. The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that

(footnote continued)

Congress itself has recognized the importance of this factor, and has recognized further that the independent directors often do not obtain the necessary information from the adviser. In the 1970 amendments, Congress amended Section 15 of the Investment Company Act to provide specifically that, in connection with the approval of an advisory or underwriting contract for an investment company, it shall be

> "the duty of an investment adviser to such company to furnish . . . such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as an investment adviser of such company.

The district court in the present case held that there was adequate disclosure by M & D to the Fund's independent directors (App. A-72). This conclusion was apparently based on numerous occasions of disclosure to the directors. For example, on January 9, 1967, defendants sent a memorandum to the directors containing a summary of the Commission's Public Policy Report, and stated that the "SEC apparently looks with favor on the practice of using brokerage

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48/ (footnote continued)

> unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company. Shareholders and potential shareholders are entitled to rely upon the implication that the unaffiliated directors are acting with full knowledge of relevant facts."

business on portfolio transactions to reduce the cost of management" (App. 307, 312). Defendants also forwarded a copy of the January 1968 release by the Commission proposing Rule 10b-10 (App. A-66) (see pp. 16-17, supra). Following the decision in Moses, defendants mailed copies of the opinion to the directors (App. A-69). Finally, the board received periodic reports from committees of the board formed to consider the question of recapture (App. A-67 - A-70).

C. The Requirement that the Independent Directors Make a Full Appraisal of all Relevant Facts

The requirement that full disclosure be made to the independent directors only has meaning if the directors actually consider the information and reach a decision independent of any domination by the investment adviser. In view of the fact that the adviser normally selects the non-interested directors,[49] it is essential that the court satisfy itself that the directors fully considered all relevant factors and were not

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49/ See, comments by the Commission's then General Counsel, Philip A. Loomis, Jr., in Conference on Mutual Funds, 115 U. Pa. L. Rev. 669, 759 (1967):

> "[The independent director] only has some power. He is probably reluctant to exercise that in a vigorous way, because it's unpleasant to [countermand] people that he likes and respects, and probably that's the only reason that he is on the board."

dominated in their decision by the adviser. 50/

Moreover, we believe that the degree of care required of the directors of investment companies, in appraising the various factors relevant to a particular determination is greater than the degree of care required of directors of ordinary business corporations. It has long been held that directors of banks, life insurance companies, and other companies which solicit the public's money and make investments with it are under a higher standard of fiduciary care than are directors of manufacturing or industrial corporations. 51/ For example, in the leading case of Hun v. Cary, 82 N.Y. 65 (1880), the New York Court of Appeals stated (82 N.Y. at 71):

> "What would be slight neglect in the care exercised in the affairs of a turnpike corporation, or even of a manufacturing corporation might be gross neglect in the care exercised in the management of a savings bank entrusted with the savings of a multitude of poor people depending for its life upon credit and liable to be wrecked by the breath of suspicion. . . ."

50/ This same requirement is imposed in an area of general corporate law--board of director ratification of transactions involving an interested director--which is analogous to the conflict-of-interest situation involved in this case. See, e.g., Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 121 N.E. 378 (1918), where it was held (per Judge Cardozo) that a board of directors could approve a transaction that involved an interested director only if it could show that it actually considered the entire question and was not influenced by the board member who benefitted from the approval. See also, Model Business Corporation Act Ann. 2d, ¶41 (Am. Bar Foundation, 1971).

51/ See, Goodwin v. Simpson, 292 Mass. 148, 192 N.E. 628 (1935); O'Connor v. First National Investors' Corp., 163 Va. 908, 177 S.E. 852 (1935); Campbell v. Watson, 62 N.J. Eq. 396, 433-37, 50 Atl. 120, 135-36 (Ch. 1901); Litwin v. Allen, 25 N.Y.S. 2d 667, 678 (Sup. Ct., 1940); Baker & Cary, Corporations, 417-18 (3d ed. 1959); Ballantine, Corporations, 161 (3d ed. 1946).

As discussed previously, the responsibility of the board of directors of an investment company is further heightened by the unusual nature of the investment company industry. Both the courts and the Congress have explicitly recognized that an investment company's board of directors has an affirmative obligation to evaluate all matters fully and carefully.

For example, in Brown v. Bullock, 294 F.2d 415 (C.A. 2, 1961), this Court imposed liability on a mutual fund's unaffiliated directors on the ground that the board had not fully considered an advisory contract before granting its approval, holding that the duties of the board were "not merely formal, but substantial." And, in 1970, the Congress confirmed that holding of this Court by amending Section 15 of the Investment Company Act to provide specifically that, with respect to the approval of advisory contracts, "[i]t shall be the duty of the directors of a registered investment company to request and evaluate . . . such information as may reasonably be necessary to evaluate the terms of an [advisory] contract . . . ."

Thus, we believe that it was necessary for the defendants in this action to show that the board of directors exercised a thorough review of all the material so as to be able to reach an informed decision independently of the investment adviser. 52/ The district

52/ In this connection, we are troubled by the fact that the board of directors of the Fund was advised by the same counsel that advised the investment adviser. As pointed out by Judge Friendly in Fogel, supra, (CCH Fed. Sec. L. ¶ 95,393, at p. 98,996):

> "It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors."

(continued)

court stated on this issue (App. A-70):

> "The Board has examined the practices each year, noted what methods were available for the Fund to recapture excess brokerage commissions, but each time concluded that it should not do so."

The court also noted the periodic meetings of subcommittees of the board composed of non-interested directors which considered carefully the question of recapture and reported on the issue to the full board (App. A-67-A-70).

The court concluded, as to this point (App. A-70):

> "[O]n the basis of this record, it is clear over the years that the Board's unaffiliated directors have given careful consideration to the issues raised by the plaintiff." 53/

D. The Requirement that the Decision of the Independent Directors Constitute a Reasonable Business Judgment

The final element which must be found is that the independent directors, after fully considering all the relevant factors, arrived at a reasonable business judgment that the course of action chosen was in the best interests of the Fund's shareholders. Defendants

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52/ (footnote continued)

The district court in the present case stated that "when questions arose the Board sought and relied on the advice of counsel which alone is sufficient to free them of liability." (App. A-79). Since the members of the Fund's board of directors are not defendants in this action, we assume that the court, although it referred to reliance by the board, actually intended to speak to the non-liability of the adviser. In any event, we disagree with what appears to be the court's conclusion -- that one may avoid liability under the securities laws simply by relying on the advice of his counsel. Reliance on advice of counsel is only one factor to be considered. and its significance in a particular case depends on the surrounding circumstances. See, e.g., Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082 (C.A. 2, 1972); United States v. Schaefer, 299 F.2d 625, 630-631 (C.A. 7, 1962); Linden v. United States, 254 F.2d 560, 568 (C.A. 4, 1958).

53/ This conclusion evidently reflected the court's findings that "the unaffiliated or disinterested Fund directors are men of repute in academia, business and the professions" (App. A-53).

cite four principal reasons in support of the board's decision not to seek recapture of the excess brokerage commissions. They state that the board believed (1) that recapture would have involved the Fund in conflicts of interest in fact and in appearance; (2) that recapture would have had an adverse impact on the sale of the Fund's shares, (3) that it was in the best interests of the Fund to allocate brokerage for research; and (4) that imminent changes in the structure of the securities industry made it unwise to change the Fund's brokerage policies to seek recapture. As we more fully discuss following our elaboration of these four reasons, while some of the reasons are not individually persuasive, we cannot say that under the particular and unique circumstance here that the decision not to recapture was clearly unreasonable.

(1) The Directors' Belief That Recapture Would Have Involved the Fund in Conflicts of Interest in Fact and in Appearance

Defendants argue that the shareholders of the Fund would not have understood the situation if the Fund had used an affiliated broker to effect recapture and would instead have believed that the adviser's investment decisions were motivated by a desire to generate brokerage commissions for its affiliate. Further, they assert that "best execution" of the Fund's brokerage transactions would not necessarily have been obtained by using the affiliated broker, since other brokers might have been able to provide better quality execution services. Finally, they state that the consistent use of the adviser to execute the Fund's brokerage transactions might have enabled members of the financial community to identify the Fund as buyer and seller and thus anticipate, to the detriment of the Fund and its shareholders, the implementation of the Fund's investment decisions (Def. Br. 23-26).

The lower court apparently based its holding that the directors exercised a reasonable business judgment on the conflict-of-interest factor, stating (App. A-81-A-82):

> "The unaffiliated directors placed a higher value on having the Fund's portfolio transactions free from any taint of self-dealing by Eberstadt; avoiding an appearance that securities in which Eberstadt has a position were being pushed and in attempting to make certain in appearance and in fact that the investments the Fund makes were based on objective good faith and not self-interest of the brokerage firm with which it is affiliated."

We do not find the reasoning of the defendants or the district court very persuasive. Regardless of whether the Fund used Eberstadt as the executing broker, the choice of securities to buy or sell was in the hands of the Fund's adviser, M & D, which could have made its decisions on the basis of the securities held by its parent, Eberstadt. With respect to the contention that the shareholders might have believed that M & D's investment decisions were based on a desire to generate brokerage commissions, we do not believe that this would have been a real concern to shareholders, since the motiviation for thus "churning" the Fund's portfolio by causing unnecessary transactions would be largely removed by the fact that, under a policy of recapture, the excess commissions would have been returned to the Fund. We are also not convinced by the argument that an astute market observer would discover the Fund's investments strategy by noticing the affiliated broker's transactions, since M & D's parent, the likely candidate for the affiliated broker in this case, was an established broker-dealer executing many orders for various customers.

With respect to the problem of best execution, which mutual funds are required to obtain, 54/ we can perceive some harm arising from the use of an affiliated broker. The need to obtain best execution may alone be sufficient in some cases to warrant a decision against using an affiliate as executing broker. 55/

Our main difficulty with defendants' conflict-of-interest arguments, however, is that a real conflict-of-interest, as opposed to the possible appearance of a conflict, could only arise in the situation where the Fund actually used the affiliate as its executing broker. None of the dangers outlined above would apply to other forms of recapture, such as give-ups and other reciprocal practices, which would not have required any participation by Eberstadt in the actual execution of the Fund's brokerage transactions (see note 15, supra).

54/ See, e.g., In the Matter of Delaware Management Co., Securities Exchange Act Rel. No. 8128 (1967).

55/ In its Public Policy Report, the Commission commented in this regard about the possibility of jeopardizing best execution (Public Policy Report, supra, n. 14, at pp. 189-190):

"Close affiliations between broker-dealers and investment companies also raise questions relating to the fulfillment of the investment company manager's duty to seek the best execution of portfolio transactions. If its affiliated broker-dealer is an exchange member, the manager of an investment company may be less inclined to consider opportunities for best execution in the third market where the affiliated broker could not earn an exchange commission. However, neither exchange membership nor affiliation with exchange members diminishes the fiduciary obligation of investment company managers to seek the best execution -- a fiduciary obligation imposed by basic concepts of trust and agency law."

(2) The Directors' Belief That Recapture Would Have Had an Adverse Impact on the Sale of Fund Shares

Defendants argue that the entire fund industry used give-ups and reciprocals to stimulate sales, and that, if the Fund had not also done so, it would have been disadvantaged in the marketplace (Def. Br. 26-27).

The primary beneficiaries of increased sales of a fund's shares are its investment adviser, which is, as noted, generally compensated on the basis of a percentage of the aggregate net asset value of the fund's portfolio, and the fund's principal underwriter, which is compensated through the sales load on each new share sold. The investment company itself derives no income from sales of its shares, nor does it participate in the profits of its adviser and underwriter. Fund shareholders, therefore, receive only such indirect or intangible benefits as are associated with a larger fund, and the studies undertaken by the Commission and others in the past indicate that these benefits may well prove to be illusory in many instances. 56/

Nevertheless, the Commission did recognize in the Public Policy Report that "competitive pressures" might militate against recapture of brokerage commissions, 57/ and the directors of the Fund apparently believed that the Fund was, as a practical matter, forced by these competitive considerations to use brokerage to stimulate sales. Defendants

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56/ See, Wharton School Study, *supra*, n. 32, at 526; Special Study of the Securities Markets, House Doc. No. 95, Pt. 4, 88th Cong., 1st Sess. 214 (1963); Public Policy Report 173.

57/ Public Policy Report, *supra*, n. 14, at p. 16.

also point out in this connection that the directors believed that proceeds from new sales were needed to avoid portfolio liquidation to meet redemption requests, and that, since there are economies of scale in managing a portfolio, an increase in the size of the fund would decrease the management cost per dollar (Def. Br. 26-27).

(3) The Directors' Belief That It Was in the Best Interests of the Fund to Allocate Brokerage for Research

The board's determination to use reciprocals and give-ups to purchase research services raises the question whether the cost of those services should have been borne by the Fund rather than by the adviser.

Traditionally, the fixed brokerage commission charged by a broker on a transaction covered not only the cost of execution, but also other costs, including the cost of research provided to the customer by the broker. Thus, the mutual fund shareholder, who bore the cost of brokerage, necessarily paid not only for execution but also for research. In the 1960's, when mutual funds discovered ways of splitting the excessive commissions they were compelled to pay, it was not unexpected that the directors and advisers of the funds continued to use brokerage to pay for research, even if the research was not being provided by the executing broker as it traditionally had been.

When it later appeared that the fixed commission rate structure might be abolished, the question arose whether the payment by a fund of a larger commission than the broker would charge for execution services alone was proper when that larger payment also purchased research services.

The Commission responded to this concern in its policy statement on the *Future Structure of the Securities Markets* as follows:

> "Presently, many institutions compensate brokers for research by allocation of commission business. If fixed minimum commissions were no longer to be applicable to institutional size transactions, an 'unbundling' process might result so that some brokers would charge separate fees for services such as execution, research and the like. Nevertheless, brokers who do in-depth research might prefer to charge higher commissions than other brokers whose research activity is narrower in scope or of lesser quality or value. Concern has been voiced that under such circumstances institutional managers charged with a fiduciary duty would be reluctant to pay a higher commission rate which reflected research. The Commission believes that they should not be. In our opinion, the providing of investment research is a fundamental element of the brokerage function *for which the bona fide expenditure of the beneficiary's funds is completely appropriate,* whether in the form of higher commissions or outright cash payments. (emphasis added). 58/

Section 28(e) of the Securities Exchange Act of 1934, 15 U.S.C. 78b(e), which was added by the Securities Act Amendments of 1975, was a legislative response to aspects of this problem. This section, in essence, permits an investment adviser to cause an investment account to pay a broker an amount of commission for effecting a securities transaction in excess of the commission another broker might have charged for effecting the transaction so long as the adviser determines in good faith that the commission was reasonable in relation to the value of the brokerage and research services provided by such broker.

In light of Section 28(e), defendants argue that the decision by the board of directors in the present case to allocate Fund brokerage for research was wholly consistent with public policy as subsequently

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58/ 37 F.R. 5286, 5290. See also, Securities Act Release No. 5250 (May 9, 1972), which contained an interpretation of the Future Structure statement on this point.

enunciated by the Congress (Def. Br. 27-29).[59/]

(4) The Directors' Belief That Imminent Changes in the Structure of the Securities Industry Made it Unwise to Change the Fund's Brokerage Policies to Seek Recapture

The latter part of the period covered by the complaint in this lawsuit was a time of fundamental changes in the structure of the securities markets. Uncertainty about the eventual content of these changes allegedly influenced the board's decision to forego recapture. In this connection, defendants cite a report of a committee of independent directors of the Fund that recommended that no change be made in the Fund's brokerage practices until the probable direction of industry change could be determined. They argue that this period of uncertainty began in 1969, but the first evidence they supply is the "Martin Report" prepared for the NYSE in 1971, which recommended that NYSE member firms be required to divest themselves of subsidiaries which manage mutual funds.[60/] They also cite the Commission's adoption of Rule 19b-2 under the Securities Exchange Act of 1934 and the amendment to Section 11(a)(1) of the Securities Exchange Act in 1975, 15 U.S.C. 78k(a)(1), which, in essence, would have prevented

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59/ The plaintiff argues that the contract between the Fund and the adviser provided that the cost of research was to be borne by the adviser (Pl. Br. 28). While we take no position on the interpretation of this contract, we note, however, that most advisory contracts in the mutual fund industry contained relatively standard provisions, including one on research, and that it was nevertheless the general practice in the industry to pay for research with excess brokerage commissions.

60/ Even prior to the Martin Report, however, on June 23, 1970, a bill had been introduced in Congress by Senator Bennett which would have regulated the utilization of exchange membership by persons engaged in investment management. S. 4004 (91st Cong., 2d Sess.). In a letter to all securities exchanges on May 26, 1972, requesting them to adopt a rule proscribing membership for affiliates of institutions, the Commission used this June 23, 1970 date as the cutoff point at which institutional investors were on notice that such fundamental changes might be implemented. See, Hearings before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess. 232 (1973).

Eberstadt or another affiliated broker from executing transactions on behalf of the Fund (Def. Br. 29-31).

(5) Conclusion as to the Business Judgment in <u>This Case</u>

We believe that the question of the reasonableness of the board's decision not to recapture in this case is a close one. Recapture would have provided direct and determinable cash benefits to the Fund, while the alternative course yielded, at best, indirect and indeterminable benefits. Nevertheless, in our view, the Investment Company Act permits this decision to be made by directors who are fully informed and truly independent; and, provided their decision is reasonable, we believe that it must be respected.

Two of the reasons cited by defendants in support of the directors' decisions are not persuasive. We disagree with the district court that recapture would have necessitated inevitable conflicts of interest. Not only are conflicts of interest an inherent part of virtually every phase of the investment company industry, but also there were recapture techniques that did not rely on execution of the Fund's transactions by the affiliated broker. Except to the extent that recapture might have created an appearance of, rather than a real, conflict of interest, we urge this Court to accord little weight to the conflict of interest factor. Similarly, we do not believe that it was sound business judgment to forego an opportunity to confer benefits on the Fund merely because of uncertainty about structural changes in the securities markets. This reason had little relevance until 1970, and even after that date, recapture did not involve major structural changes in the Fund's operations that could not quickly be adjusted to conform to any future changes in the markets.

The remaining reasons given by defendants are more persuasive. While the Commission has historically taken the position that new sales confer only questionable benefits on existing shareholders, in view of the competitive consideration arising from the virtually universal use in the industry of excess commissions to pay for sales, a decision by the directors of a particular fund that increased sales would be beneficial to that funds' shareholders is not necessarily unreasonable. We also believe that it was reasonable for the directors to continue the long-standing practice, recently confirmed by Congress, of using brokerage commissions to pay for research.

Although, as already noted, this is a close case, we believe that the directors reached a reasonable business judgment. Several factors have influenced this conclusion. First, we have assumed that the district court's finding on the independence of the board, despite our general experience to the contrary, is correct; should this Court overturn that finding, a different case would be presented. Second, we have approached this question cognizant of the uncertainties that confronted the directors at the time their decisions were made. In view of the lack of guidance on the legal and economic issues involved in the recapture decision, we do not believe that it is appropriate to judge the decision from the perspective of the present time, when many of these issues have been

resolved.[61/] Finally, although we have discussed separately each of the four reasons cited by the defendants in support of the decision not to recapture, it appears that the directors considered the reasons in the aggregate; and viewed from that perspective, we believe that those reasons support the conclusion that the directors exercised a reasonable business judgment.[62/]

61/ The resolution of one aspect of the recapture problem did not occur until 1972, but that resolution is even now being questioned. In 1972, the Commission requested the National Association of Securities Dealers, Inc. to prohibit the reciprocal practices whereby mutual fund advisers directed the funds' brokerage orders to particular broker-dealer firms as a reward for those firms' efforts in selling the funds' shares. The Commission is now considering a recent proposal by the NASD to amend the rule that the Association had adopted in response to the 1972 request from the Commission.

62/ Although we believe that the defendants should not be held liable either under former Section 36 or under new Section 36(a), their non-liability is even clearer under the old provision than the new one, in view of the old requirement that a "gross abuse of trust" be established.

In the event that this Court upholds the district court's finding that the directors were truly independent of the adviser but disagrees with the conclusion that their decision not to recapture was a reasonable business judgment, a further issue, which has not been discussed by the parties, would arise. That issue is whether an investment adviser may be held liable for implementing and receiving the benefits of a decision made by independent directors over which it has no control, when that decision is an unreasonable business judgment. This question would arise only rarely, in view of the unlikely occurrence of a situation in which the directors (1) would be truly independent of the adviser and (2) would make an unreasonable judgment which (3) benefits the adviser. Although we do not need to reach this issue in this brief, we point out that the adviser is subject to its own fiduciary obligations to the fund and the fund's shareholders.

CONCLUSION

Assuming that this Court is satisfied (1) that defendants have met their burden of establishing that the noninterested members of the board of directors were fully informed by the adviser of all relevant facts, (2) that these directors in fact acted independently of domination by the adviser and made a full appraisal of those facts, and finally, (3) that the decision of the board was based on good faith reliance on the reasons given by the defendants, then, for the reasons set forth herein, we believe that the decision of the district court should be affirmed.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SUSAN TANNENBAUM, Plaintiff-Appellant, v. ROBERT G. ZELLER, et al., Defendants-Appellees.	No. 75-7503

CERTIFICATE OF SERVICE

I hereby certify that on May 5, 1976, I caused two copies of the final printed Brief of the Securities and Exchange Commission, Amicus Curiae, in the above-captioned matter, to be mailed, postage paid, to each of the following counsel:

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